Information Request DTE 1-30

Refer to Exhibit SU-3. How does the Company determine the level of retained earnings it will carry on its books?

Response

Consistent with accounting conventions, "Retained Earnings" recorded on the balance sheet always represent the total net earnings of a company less any dividends that may have been distributed to shareholders in the past.

When a company issues a stock dividend, cash is not expended. However, Retained Earnings are reduced at the end of each fiscal year when the stock dividend is distributed. The amount of the reduction to Retained Earnings depends on several factors, which are discussed below.

On the balance sheet, Retained Earnings are a component of Common Stockholders' Equity. With a cash dividend, the pay-out of earnings reduces Common Stockholder's Equity (because Retained Earnings are reduced by the amount of the dividend). With a stock dividend, there is no change to Common Stockholder's Equity, because the journal entry that reduces Retained Earnings also increases the Common Stock, $1 Par and Premium on Capital Stock (in combination), by the amount of the reduction to Retained Earnings. As a result, there is no net change in the Common Stockholders' Equity from a shareholder's perspective.

For example, if the Company has earned $50 million in net income at the end of the fiscal year and issues 3 million shares of common stock (as a five percent dividend) each worth $14.00 as of the dividend date, the value of the stock dividend would be $42 million. Thus, the journal entries to account for the dividend would reduce Retained Earnings from $50 million to $8 million and the $42 million would be reclassified from Retained Earnings to Common Stock, $1 Par Value ($3 million) and Premium on Capital Stock ($39 million). Accordingly, there is no change in the overall level of Common Stockholders' Equity.

If the 3 million shares of common stock were worth $18.00 per share on the dividend date, or $54 million, the total amount of Retained Earnings ($50 million) would be reduced to zero and reclassified as Common Stock, $1 Par Value ($3 million) and Premium on Capital Stock ($47 million). Once again, the overall level of Common Stockholders' Equity would remain the same from the shareholder's perspective.

It should be noted that, in the latter example, the fact that the common stock shares have a market value of $54 million in comparison to the $50 million in retained earnings does not mean that the Company is "paying out" more than it has earned in the year. The stock dividend is not a payment to shareholders, as is a cash dividend. Nor is the Company raising capital when it issues the stock dividend. The capitalization of the Company is not expanded or increased as a result of the dividend distribution. Thus, the stock dividend effectively represents a "stock split" in that the shareholder continues to hold the same ownership share in the Company, albeit spread across additional shares. If the shareholder held 100 shares with a book value of $10/share before the stock dividend, he or she will hold 105 shares with a book value of $9.52/share after the stock dividend. Accordingly, the fact that the market value of the stock is greater than the amount of retained earnings has absolutely no impact on shareholders, customers or the financial health of the Company. It is only relevant to the determination of the level of Retained Earnings that are reclassified within the category of Common Stockholders' Equity.